Crypto Lending Good Practices

Recommended by the Crypto Credit Association

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Overview

Traditional financial lending benefits from many years of accrued experience and norms that help organisations, customers, and other stakeholders reduce risks stemming from irresponsible lending practices. In recent decades, risk management has often lagged behind accelerating innovation in financial products, leading to enhanced scrutiny by regulators attempting to limit unsustainable business techniques through tighter rules.

These include EBA *Guidelines on Credit Risk Management*[1], Basel *III Principles for the Management of Credit Risk*[2], FINRA resources on credit risk management[3] and a wide range of national and international regulatory recommendations and binding rules. At the same time, industry-and NGO-driven voluntary good practice frameworks have grown in complexity and maturity.

Crypto lending is a relative newcomer to the financial industry, and its fastest-developing area. Through blockchain-related technologies and DeFi lending, it already incorporates significant technological controls for limiting both lender and borrower risk.

Nonetheless, many current rules and standards for traditional lending also apply to cryptofinance. Furthermore, regulators often perceive the potential for economic damage from crypto lenders who fail due to poor business practices, including insufficient credit risk management.

The Crypto Credit Association believes that self-imposed, responsible, and actionable credit risk management practices are preferable to regulation that can stifle innovation and harm smaller, newer firms. Crypto lenders and lending platform operators, whether decentralised or centralised, should incorporate both applicable existing credit risk management practices as well as crypto-specific risk management considerations into their own risk management practices. Through such practices, the industry can not only better manage its own financial risk, it can also help guide and encourage lawmakers to focus on reasonable, pragmatic regulations.

This white paper is a selection of high-level guiding principles for effective credit risk management. The list is not exhaustive, nor is it legal guidance - it is based on CCA members' experience in both crypto lending and traditional finance, and designed to help crypto lenders and lending platform operators ensure they are on the right track.

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[1] https://www.eba.europa.eu/regulation-and-policy/accounting-and-auditing/guidelines-on-accounting-for-expected-credit

[2] https://www.bis.org/publ/bcbs54.htm

[3] https://www.finra.org/rules-guidance/guidance/reports/2022-finras-examination-and-risk-monitoring-program/credit-risk-management

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I. Structural Practices

1. Risk Management - you must have a financial / credit risk management framework, based on accepted standards whenever possible, and ensure that this is adhered to in practice. You should also be aware of which aspects of existing credit risk frameworks do not apply to crypto lending, and when crypto-specific controls are not available, incorporate this knowledge into your risk management practices.

   You are a financial services organisation - practice credit risk management like one.

2. Risk Appetite and Governance - have you defined clear responsibilities and accountability for understanding and reporting your level of permissible risk, and the risks you determine based on your credit risk management framework? Is your board and management aware of these, and have they signed off on your credit risk appetite?

   Have a clearly defined risk appetite that is approved by your board and leadership, and ensure that they are made aware of risks exceeding your risk appetite.

II. Legal and Regulatory Considerations

3. Jurisdiction and Lender Rights and Recourse – these are crucial to understand. Much legal (contractual and regulatory) risk can be controlled with robust lending agreements, but legal recourse is harder in some jurisdictions than others. Is it clear in which jurisdiction(s) you are exposed to? Is the rule of law in these jurisdictions trustworthy? Is there a Mutual Legal Assistance (MLA) treaty with your home location? Are you using a smart contract/electronic signature, or wet ink, and if the former, is a smart contract legally enforceable in the relevant jurisdiction(s)?

   Understand the legal systems that you and your contracts are subject to, as well as your rights and restrictions in these jurisdictions.

4. AML/KYC – does your lending operation reliably check whom and where the money is coming from? Are you sure that this meets legal requirements in any applicable jurisdiction(s)?

   You must follow all applicable laws to ensure counterparty and fund legitimacy and transparency.

5. Product Appropriateness – is your product appropriate for retail customers? Are you issuing securities? Whether you are using a DAO or a smart contract, if it issues securities, you must either geographically restrict its availability if legally required, or conduct appropriate checks on lenders. Performing regulatory arbitrage on-chain ultimately results in bad outcomes for participants.

   Understand and comply with all market and securities laws that apply to your products and services, in all relevant jurisdictions.

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III. Credit Risk Management

6. Borrower Due Diligence – crypto entities especially are pretty complex, often offshore, and bankruptcy law in each is never straightforward. Ultimate Beneficial Owners (UBOs) are often intentionally obfuscated, and hence ultimate credit risk is hard to see.

   Know who your counterparty is, and who their UBOs are.

7. Proper Underwriting – investigative work around liabilities and asset verification is challenging, and requires a mixture of technical tools and a lender being willing to ask the difficult questions. This is significantly eased by verifiable correctness of provided information.

   Ensure financial statement consistency, veracity, and history, and that you can validate any trends in these statements.

8. Collateral – it is important to always be aware of the realistic value of collateral, and the role of all parties involved in its management and allocation.

   a. Quality of collateral – is it a made-up token issued by the borrower? Duh. Is it liquid? What is its realistic liquidity in stressed times (not just right now)?
   b. Allocation of collateral – does anyone else have a claim to this collateral? Is it likely to be clawed back by others in a bankruptcy?
   c. Valuation of collateral – can the collateral be effectively priced at any time?
   d. Rehypothecation – can/should you rehypothecate the collateral, and if so, does this change the above?
   e. Third party managers – is a security agent, regulated ATS, or some other licensed, verifiably trustworthy party securing your collateral, or is it just the lender? What legal resources are available in case of negligence or malfeasance?

   Always have a realistic view of the dependability of all aspects of collateral.

9. Loan Risk Modelling - have you documented your underwriting risk standards, and do you revise these at regular intervals? Are they based on generally accepted methodologies such as Basel II/III IRB? Do you understand how your credit risk assessment system works, and is it integrated into your decision making process? Can you assign clear and reproducible metrics to identified risks? Do you regularly review your risk management framework?

   Ensure that the system being used to evaluate risk is robust and up to date.

10. Loan Risk Monitoring – do you use your risk management framework and capabilities to actually keep abreast of loan risk as part of business-as-usual activity? Do you have a process for not only reporting loan risk, but acting on changing circumstances?

    Make sure you realistically and regularly evaluate loan risk based on reviewed, empirical mechanisms and standards.

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11. Transparency of liabilities – are you aware of your counterparties' exposure to financial risk and credit liabilities? If not, is this baked into your loan risk assessment, and in line with your organisation's risk appetite? Are you actively using any resources, such as trusted ledgers and other sources of information?

    Actively use any available resources, such as trusted ledgers, that help you maintain the most complete and accurate information possible about counterparty liabilities and risk.

12. Portfolio diversity – Borrowers may default unexpectedly despite diligent analysis. To minimize this risk, ensure sufficient diversity among your counterparties. Are you actively looking out for potential single points of failure? Does the number and diversity of borrowers correspond to your risk tolerance?

    Avoid single points of failure arising from excessive dependence on too few counterparties

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